



21 Dupont Circle, NW Suite 750
Washington, DC 20036
202.204.7900
www.bdamerica.org

July 24, 2014

VIA ELECTRONIC MAIL

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Robert E. Feldman
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW
Suite 3E-218
Mail Stop 9W-11
Washington, DC 20219

RE: Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High-Quality Liquid Assets, Docket No. R-1514; Regulation WW and RIN 7100 AE-32

Ladies and Gentlemen:

On behalf of the Bond Dealers of America (“BDA”), I am pleased to submit this letter in response to the Board of Governors of the Federal Reserve System’s proposed rule to amend the Board’s Liquidity Coverage Ratio (LCR) rule to include a limited subset of general obligation municipal securities as high-quality liquid assets (HQLA). BDA is the only DC based group representing the interests of middle-market securities dealers and banks focused on the United States fixed-income markets and we welcome this opportunity to present our comments on this rule proposal.

BDA appreciates that the Board has appropriately chosen to recognize municipal securities as liquid assets issued by highly creditworthy issuers. However, the limitations the Board places on municipal securities are not appropriate given the superior credit characteristics of investment grade municipal securities relative to other HQLAs, including corporate bonds and corporate equities, and the proven track record of municipal securities to retain value during market sell-offs. The proposed amendments apply restrictions and limitations on municipal securities that do not exist for other investment grade HQLAs, like corporate bonds and equities, which have generally exhibited greater susceptibility to sharp downside price risk during periods of market volatility than municipal securities.

BDA believes the Board has placed too much emphasis on trading volume and too little emphasis on the historical market price risk of different HQLAs under stress. By doing so, the Board restricts the ability of a financial institution to use a wide variety of investment grade municipal securities, which could retain value and be liquidated at advantageous prices relative to corporate debt and corporate equities. BDA believes that the aggregate impact of the proposed limitations creates a treatment for municipal securities that is at odds with the fundamental purpose of the regulation—to require financial institutions to hold the highest quality assets that can be readily converted to cash during a liquidity crisis.

BDA urges the Board reconsider the proposed limitations and to consider an approach that recognizes a wide variety of investment grade municipal securities as eligible for HQLA treatment as Level 2A assets.

The exclusion of revenue bonds unnecessarily excludes bonds that are high-quality-liquid assets.

The preamble to the proposal indicates that revenue bonds were excluded from HQLA treatment because they involve exposure to a single asset or source of revenue. We do not believe that this is the case for a major portion of municipal revenue bonds. Many of the largest municipal revenue bonds are bonds backed by revenues from a wide variety of systems or assets. Examples of these include revenues from electric, gas, water, and sewer derived from an entire utility system; Highway revenue bonds backed by the revenues from large transportation systems, or assets and other transportation revenue bonds that are backed by urban bus and subway systems; And hospital and university revenue bonds that are backed by revenues from an entire hospital or university system (rather than a single asset). Further, many governmental entities issue bonds that are not general obligation bonds but that are backed by revenues from generally applicable taxes or similarly broad revenues: sales taxes, hotel and tourism taxes, lottery revenues, etc. In short, we believe that the exclusion of revenue bonds from HQLA status is based on a misconception and, accordingly, the rules should be revised to generally include investment grade revenue bonds.

The Board, by choosing to restrict the ability of an institution to include investment grade revenue bonds as HQLA, has excluded over half of the municipal securities issued in 2015. BDA believes that an institution should be able to include investment grade revenue bonds in their HQLA holdings. According to a recent Moody's report, 72.22% of the 72 non-GO municipal bond defaults that occurred between 1970 and 2013 were concentrated in two distinct categories of revenue bonds. By excluding all revenue bonds, BDA believes the Board is unnecessarily excluding many of the highest quality and most liquid and actively traded municipal securities from HQLA consideration permanently.

BDA recognizes, as the Board notes, that—by definition—the value of revenue bonds is based on the expectation of a future revenue stream or streams. And, depending on the cyclical nature of the revenue, may become stressed in an economic downturn. However, BDA notes that the value of corporate bonds, an asset class with a higher historical default rate than municipal securities, is wholly tied to the uncertainty of future corporate revenues

materializing. Bank capital risk-weights recognize the greater credit risk posed by corporate bonds by subjecting those exposures to a 100% standardized risk weight, as opposed to a 20% risk weight for GO bonds and a 50% risk weight for revenue bonds. Yet, investment grade revenue bonds that could retain their value throughout a liquidity crisis — when corporate revenues could be falling sharply — are categorically excluded from being considered HQLAs. BDA believes that the Board should allow financial institutions to include investment grade revenue bonds as HQLAs and objects to the proposed blanket exclusion of revenue bonds.

The cumulative effect of the proposed restrictions placed on municipal securities effectively negates the ability of an institution to use municipal bonds to comply with the Liquidity Coverage Ratio.

The proposed exclusion of all revenue bonds irrespective of credit quality and the other proposed limitations on municipal securities effectively limits the municipal securities that would be eligible for inclusion as HQLA to less than 40% of securities issued in 2015. The stringent limits placed on investment grade general obligation municipal securities further restricts the quantity of municipal securities eligible for inclusion and the overall utility of the proposed amendments. No other asset class is subject to as many stipulations and restrictions.

- ***The requirement that limits an institution's holdings of municipal securities as HQLA to 25% of an individual CUSIP will negatively impact smaller issuers.***

The 25% cap will reduce the demand that financial institutions may have for bonds issued by serial GO issuers in the future. An institution that must comply with the requirements of the liquidity coverage ratio will be prevented from counting greater than 25% of any CUSIP as an HQLA. But, based on the size of serial issuances, owning greater than 25% of a CUSIP would not prevent an institution from selling the entirety of their position to raise cash in a liquidity crisis. This portion of the proposal is problematic for the largest GO issuers and has the potential to be highly disruptive for smaller GO issuers.

For example, an institution may hold \$500,000 of one \$1 million CUSIP in an overall offering of \$50 million with 15-20 distinct maturities issued by a municipal issuer. By basing the limit on a percentage, the Board is including positions in municipal securities, such as a \$500,000 position, that an institution could sell swiftly in far less than 30 days. The same principle applies to a larger issuer that issues \$2-\$4 million serial maturities as part of a \$150 million issuance.

Unlike corporate bonds, which are typically issued with a single large maturity, municipal bond issues are typically structured with a mix of serial and term bonds to produce the desired debt service structure (e.g., level debt service or level principal) and to appeal to different segments of the investors. As a result, even the largest municipal bond issues will typically have multiple maturities resulting in multiple CUSIPs for the bond issue, with the serial bonds and, at times, even some of the term bonds having relatively modest principal amounts. It will unreasonably restrict HQLA status for municipal bonds if the 25% limitation is imposed separately for each CUSIP. At a minimum, the limitation should be applied on the basis of an entire bond issue. More appropriately, we believe that the limitation should be

applied on the basis of the issuer and its credits, regardless of whether the bonds are part of the same CUSIP. If a State issues transportation revenue bonds in multiple bond issues on a parity basis under the same credit structure, there is no reason to apply the 25% limitation separately to the bonds issued in 2012 versus those issued in 2013.

BDA urges the Board to remove the CUSIP restriction and allow financial institutions to include investment grade municipal securities set aside as HQLA in quantities that the regulated institution believes can be sold within a 30 day period. This is the standard that applies to other assets, including corporate equities and corporate debt, which have more rapidly lost value in past liquidity crises compared to municipal securities.

- ***The requirement that limits an institution's holdings of municipal securities as HQLA to 2x of the average daily trading volume of an issuers' GO bonds is unwarranted and unworkable.***

BDA is unaware of any regulatory data source, such the Municipal Securities Rulemaking Board's Electronic Municipal Market Access (EMMA), that could enable an institution to accurately track the average daily trading volume of an issuers GO debt. Currently, EMMA does not have the ability to aggregate data across all of an issuer's CUSIPs or the ability to separate out the GO debt from the non-GO debt of an issuer. This trading volume-based cap, coupled with the CUSIP ownership limitation, is another unnecessary restriction.

From a market-based perspective, this backwards-looking measurement is flawed because it would likely ignore periods of increased volume that occur in the municipal market when opportunistic buyers buy bonds as yields rise—effectively stemming downward price movements. Similar to a non-stressed value-at-risk (VaR) measurement, designing the volume cap to be based on a prior twelve month period when no period of significant volatility may exist during that period would not provide useful information about the ability of an institution to sell municipal securities during periods of market volatility when municipal securities trading volumes rise. The trading data that would be used, if it was readily available, to compute the limit would, in most cases, show that trading volumes in the municipal securities market are muted because investors in the municipal market buy assets to hold them through maturity because of low credit risk and the tax preferred status. As a result, according to the Municipal Securities Rule Making Board (MSRB) nearly 75% of trades--based on the par amount of municipal securities with maturities of two years or greater--are executed within five years of the sale date. Thus, the volume limitation of the proposed rule would be unnecessarily detrimental to securities strictly due to the time that elapses post-sale despite the fact that these securities could be sold for fair market value.

Municipal securities form the core holdings of many individual investors and institutions, a fact that limits downside price risk in municipal securities. These market dynamics reduce forced-selling and increase opportunistic buying in stressed situations when other assets, including corporate equities and corporate debt, may be more frequently liquidated at fire-sale prices. This dynamic is only strengthened by the tax-preferred status of municipal securities.

- ***The requirement that limits an institution's holdings of municipal securities as HQLA as Level 2B assets to five percent of the institution's total HQLAs.***

On top of the CUSIP limit and trading volume cap, the Board further proposes to limit an institution's HQLA holdings of municipal securities to five percent. This limit is in addition to the limit of 40% that is applicable to Level 2 assets generally and the 15% limit that is applicable to Level 2B assets and is the only asset-specific limit within any category of the rule. BDA believes the Level 2B 15% limit and the 5% limit applicable to GO, uninsured municipal securities is completely unnecessary and it limits the ability of institutions to fulfill their regulatory requirements with the use of municipal securities, which have a demonstrable track record of retaining their value during market volatility.

- ***The requirement that prohibits an institution's from including holdings of insured municipal securities as HQLA.***

BDA urges the Board to allow a financial institution subject to the LCR to include investment grade, insured municipal securities as HQLA only if the securities would be considered investment grade in the absence of insurance. BDA believes that the Board's prohibition on including insured municipal securities as HQLA due to concerns over wrong-way risk will unnecessarily exclude investment grade municipal securities issued by issuers whose securities trade in the secondary marketplace at prices that indicate the issuer has ample capacity to make timely payments of interest and principal in the future—and not primarily based on the “wrap”.

BDA believes that insured municipal securities and the companies that insure municipal securities do not represent the type of highly correlated wrong-way risk that is present when a financial institution holds the debt of another financial institution, a situation that is properly prohibited by a rule that contemplates a broad-based banking liquidity crisis. By excluding insured municipal securities, the Board excludes liquid securities issued by highly creditworthy issuers that benefit from a second layer of credit protection.

BDA urges banking regulators to work cooperatively to amend the Liquidity Coverage Rule to include investment grade municipal securities without burdensome limitations.

In conclusion, BDA urges the Board along with the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC) to act cooperatively and issue a harmonized amended final rule that includes municipal securities. BDA believes that the restrictions that have been proposed by the Board place restrictions on municipal securities that are unwarranted, especially given the relative credit and pricing risks of corporate equities and corporate debt. By placing an over reliance on trading volume metrics, as opposed to credit quality and historical market performance, BDA believes the Board has devised a proposal that fails to recognize that municipal securities are a solid store of value that outperform other asset classes during periods of market stress.

Thank you again for the opportunity to submit these comments.

Sincerely,

A handwritten signature in blue ink, appearing to read "M. Nicholas", with a stylized flourish at the end.

Michael Nicholas
Chief Executive Officer